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UNCLAS SECTION 01 OF 03 BRASILIA 001566

SIPDIS

SENSITIVE

STATE PLEASE PASS TO USTR
NSC FOR BREIER
DEPT OF TREASURY FOR FPARODI
USDOC FOR 3000/JOHN TOCCO
USDOC FOR 3134/USFCS/OIO/WH/EOLSON
USDOC FOR 4332/ITA/MAC/WH/OLAC/MWARD
USDOC FOR 6950/DEAN WODDARD - AEROSPACE
DOT FOR SUSAN MCDERMOTT, CAROLYN COLDREN
FAA MIAMI FOR MARK RIOS

E.O. 12958: N/A
TAGS: EAIR EINV PGOV ETRD BR
SUBJECT: VARIG FINANCIAL CRISIS DEEPENS

REF: A) 2004 BRASILIA 2939, B) RIO DE JANEIRO 198

¶1. (U) This cable is based upon information gathered by the Econ and FCS Sections at AmEmbassy Brasilia.

¶2. (SBU) Summary. The financial situation of VARIG, Brazil's troubled flagship carrier, is worsening. Airline officials have told Deputy Senior Commercial Officer that in the absence of some sort of rescue package the company would only survive 30 days. So far, however, key GOB officials have not signed on to the restructuring deal being negotiated by VARIG's new board. Meanwhile, one of companies which leases aircraft to VARIG has demanded the return of its planes because of the failure of the airline to pay the lease expenses. We foresee the current crisis shortly becoming very public and very messy. End Summary.

¶3. (SBU) On June 7, USCS Deputy Senior Commercial Officer (DSCO) telephoned Vice-President (and Defense Minister) Alencar's Chief of Staff to inquire about the status of VARIG. Our interlocutor pledged to pass this query to VARIG; ten minutes later VARIG President Henrique Neves called back to relay the following information:

-- On May 9, VARIG's management was taken over by a new board of directors comprised of executives from major multinational corporations doing business in Brazil. The Rubem Berta Foundation (i.e., the VARIG employee association), which proved incapable of making difficult decisions, now no longer has any direct involvement in company management.

-- VARIG and the Portuguese airline TAP are working on a 4-stage plan to return the company to financial health. Stage 1 of the plan contemplates conversion of much of VARIG's outstanding debt into equity shares of a reorganized corporation.

-- Stage 2 of the plane envisions TAP purchasing 20 percent (US$300 to $400 million) of the reorganized corporation. This, along with the debt restructuring, would generate approximately US$500 million.

-- Stage 3 involves VARIG and the GOB coming to an accord, whereby the latter agrees to drop its appeals to a US$1.1 billion judgment in the airline's favor and VARIG, after a six-month grace period, agrees to start paying its debt to the GOB.

-- Finally, in Stage 4 the shares from the newly-formed VARIG would be sold on the market and the creditors who became asset holders would then receive their cash.

¶4. (SBU) Significant obstacles stand in the way of the realization of this plan. First, VARIG reports that while creditors such as Boeing and GE Engines have agreed to the plan, leasing companies with newer planes - such as the International Lease Financing Corporation (ILFC), a subsidiary of AIG -- are balking as they believe that their aircraft could be profitably diverted to another paying lessee. VARIG worries that if ILFC, which supplies 11 of the company's 82 aircraft, remains recalcitrant, other lessors (like GECAS, GE's leasing arm) may adopt a similar stance. (Indeed, even the extent to which Boeing is on board is still up in the air as in our contacts with Boeing representatives they declined to confirm any accord with VARIG.) And without the debt-for-equity swap, TAP would not proceed with the purchase of 20 percent of the restructured company.

¶5. (SBU) Second, key questions such as who would control the restructured company and the status of TAP's debt to the GOB remain unresolved. Given its substantial investment, presumably TAP would want a majority of the

voting (as opposed to the common) shares of the company. However, Brazilian law explicitly provides that foreign investors in the aviation sector may hold no more than 20 percent of the voting shares of a carrier. In addition, TAP itself owes approximately US$23 million in taxes to the GOB, although it maintains that a 2002 presidential decree partially extinguished at least part of this debt.

¶6. (SBU) Third, the GOB has not yet agreed to drop its appeal in the US$1.1 billion court case, nor has it agreed to the six-month moratorium on payment of outstanding debt owed to government agencies. Presidential Chief of Staff Jose Dirceu publicly characterized a recent meeting between VARIG, TAP, and high-level Lula administration officials on this issue as a "waste of time," federal attorneys who have reviewed the matter have weighed in against such a transaction. Among other things, Dirceu and Finance Minister Palocci likely worry that if the government cuts a special deal for VARIG, it may face similar demands from both plaintiffs with similar lawsuits and recalcitrant debtors with just as compelling excuses. For its part, VARIG reports that Dirceu has pledged that the GOB will analyze the carrier's proposal and respond within ten days after the June 2 meeting. Meanwhile, VARIG says the GOB has released US$40 million in cash to allow the company to make its payroll.

¶7. (SBU) Finally, even after the restructuring was completed, Neves told DSCO that the company would need to lay off 5,000 employees and gain access for four to six months to a US$100-150,000 line of cash per month. And while the new airline would possess key national and international routes, it would also inherit a fleet of aging, high-maintenance aircraft, declining market share, and stiff competition from an increasing array of low-cost domestic carriers.

¶8. (SBU) Comment. There is ample reason to believe that the hour of reckoning for VARIG has arrived. Unidentified VARIG officials have been quoted in the local press as stating that without a rescue package the airline won't be able to survive past year's end. Neves was even more pessimistic, declaring that if the restructuring did not work the airline would only survive 30 days. While VARIG certainly has an ulterior motive for emphasizing its dire straits, the tone of its contacts with the Embassy over the past few days has become increasingly desperate. Whether the proposed restructuring will inject enough capital into the carrier to actually satisfy all the creditors will soon become apparent. Now could truly be make or break time for the airline.

¶9. (SBU) While Vice President Alencar -- the GOB's principal point man on VARIG issues -- has vacillated between a bail-out and the "let the market resolve the situation" option, VARIG's selection of a new management team may well have precipitated its end rather than its rescue. The new president of the company's Administrative Council is David Zylbersztajn, the son-in-law of former President (and now opposition leader) Fernando Henrique Cardoso. Analysts here had worried that Zylbersztajn and his hand-picked team, members of which are closely associated with the PSDB - i.e., the rival party to the Lula administration, would set VARIG on a "collision" course with the GOB.

¶10. (SBU) Who blinks first and the ultimate consequences for VARIG are still open questions. While the demise of VARIG, for years the country's flagship carrier, would definitely be a bitter pill for the Brazilian public to swallow, the prospect of a cash-strapped government using public funds to heal a private company is medicine just as unpalatable.

Danilovich